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SUBJECT: ICELAND: INVESTMENT CLIMATE STATEMENT 2009

REFS: A) 08 STATE 123907 B) Evans-Hatcher email 1/28/09

¶1. (U) Post submits the following Investment Climate Statement for Iceland for 2009. Responses are keyed to reftel. This report has been sent by unclassified email to J. Nathaniel Hatcher in EEB/IFD/OIA per reftel instructions. The statistics portion at the end of this report was only sent by email (Ref B).

¶2. (U) Begin report:

--Openness to Foreign Investment

The Icelandic Government encourages foreign investment in most sectors. The majority of investment is in energy-intensive industries such as aluminum smelting that take advantage of the country's abundant renewable energy resources. Icelandic laws regulating and protecting foreign investments are consistent with OECD and European Union (EU) standards. As Iceland is a member of the European Economic Area (EEA), most EU commercial legislation and directives take effect in Iceland. The major law governing foreign investment is the 1996 Act on Investment by Non-residents in Business Enterprises, which grants national treatment to non-residents of the EEA (including U.S. citizens). The law dictates that foreign ownership of businesses is generally unrestricted, but with limitations in fishing, energy and aviation sectors. Non-residents cannot own more than five percent in fishing and fish processing companies; cannot hold hydro and geothermal power harnessing rights and cannot manufacture or distribute energy; and cannot own more than 49 percent in aviation companies. However, according to the Ministry of Industry, the restrictions on manufacturing energy can be avoided by establishing a holding company somewhere in the EU that operates the power plant. Icelandic law also restricts the ability of non EEA-citizens to own land, but this may be waived by the Ministry of Justice. Icelandic courts uphold the sanctity of contracts as a matter of course. The Competition Authority is responsible for upholding the competition law and obligations under international agreements.

There is no automatic screening of investors, although bidders in privatization sales may have to go through a pre-qualification process. Potential U.S. bidders in privatization auctions need to follow the process closely, since the procedures are often ad hoc and deadlines can be short. The U.S. does not have a bilateral investment treaty (BIT) with Iceland. A Trade and Investment Framework Agreement was signed on January 15, 2009.

The Icelandic economy experienced high volatility in 2008, due partly to the size of the economy, the currency and the global liquidity crisis. The 12-month inflation in December 2008 measured at 18.1 percent. Over the course of 2008 the stock market index OMX 15, which consisted of the 15 companies listed on the OMX Iceland Stock Exchange with the highest market capitalization, went from 6318.02 to 352.16. At present only ten companies make up the index. In the same time period the krona devalued 100 percent against the dollar, from 62 ISK to USD to 120.87 ISK to USD as measured by the

Central Bank of Iceland. Both the OMX 15 and the exchange value of the ISK had been appreciating rapidly in previous years. In October 2008 the government took over control of the three big Icelandic commercial banks.

--Conversion and Transfer Policies

Until recently, Icelandic law provided for full convertibility and transferability of dividends, profits, interest on loans, debentures, mortgages, lease payments and invested capital. However, following the financial turmoil in fall 2008, movements of capital to and from Iceland were restricted by the Rules on Foreign Exchange issued by the Central Bank in November 2008 and amended in December 2008. These rules are supposed to be temporary measures to strengthen and stabilize the exchange rate of the ISK and are scheduled to be revised no later than March 1, 2009.

The rules restrict the outflow of foreign currencies from Iceland unless the currency is used to import goods or services or to travel. This means at the present time that foreign investors in Iceland cannot remove their capital. The rules allow for purchasing foreign currencies to pay on interest, indexation, dividends, capital gains, contractual installment payments and salaries. It is prohibited to settle transactions of transferable financial instruments denominated in ISK in foreign currencies, and to conduct cross-border prepayment of financial instruments. Sales proceeds from transactions in financial instruments that take place in Iceland must be deposited in to the seller's account in Iceland. Purchasing of foreign currencies by means of withdrawals from ISK-denominated bank accounts at domestic financial institutions or the Central Bank is not allowed, as is withdrawing foreign currencies in cash from foreign currency-accounts in Iceland without demonstrating that it will be used to pay for goods and services. Borrowing and lending between domestic and foreign parties for purposes other than cross-border transactions with goods and services is not allowed if the amount exceeds 10,000,000 ISK.

--Expropriation and Compensation

As far as the U.S. Embassy is aware, the Icelandic government has never expropriated a foreign investment. Some actions of the Icelandic government immediately before and during the financial crisis in October 2008, including the Central Bank takeover of 75 percent of Glitnir Bank (thereby causing the value of the bank's shares to plummet in value) and the subsequent takeover of the three major banks with significant foreign investment interests, have been described by private investors as an expropriation of sorts. However, the assets and claims against the banks are still being evaluated (see dispute settlement). The Constitution of Iceland proclaims that no one may be obliged to surrender his property unless required by public interests and that such a measure shall be provided for by law and full compensation be paid. A special committee is appointed every five years to review and proclaim the legality of expropriation cases. If the committee proclaims a case to be legal it will negotiate an amount of compensation with the appropriate parties. If an amount cannot be agreed upon, the committee determines a fair value after hearing the case of all parties. Cases of expropriations are fairly rare and in most cases involve real estate and land being expropriated because of water and power facilitation, road construction, city planning or things of similar nature.

--Dispute Settlement

Iceland has ratified the major international conventions governing arbitration and the settlement of investment disputes. Iceland accepts binding arbitration of investment disputes.

After the Government took over control of the three big Icelandic commercial banks in October 2008, it separated the bank's domestic operations from their foreign operations and passed a bill that places the claims of depositors as top priority. Currently debtors, some of whom are American, are negotiating with the government on how to settle claims on the banks. As of now it is not clear how they will be compensated. There are no other recent cases of major investment disputes involving foreign investors in Iceland and the Icelandic system has been considered well equipped to handle any trade and investment dispute.

The Icelandic civil law system enforces property rights, contractual rights and the means to protect these rights. The Icelandic court system is independent from the parliament and government. Foreign parties must abide by the same rules as Icelandic parties, and they

enjoy the same privileges in court; there is no discrimination against foreign parties in the Icelandic court system. When trade or investment disputes are settled, the settlement is usually remitted in the local currency.

Under the Constitution, sentences may be passed by the courts only. The courts are divided into two classes: the Lower Courts, where most cases are heard, and the Supreme Court, which hears appeals from the lower courts.

There are eight lower courts and one Supreme Court, all hearing private and public cases. A special court called the Labor Court is concerned with labor disputes.

Iceland has been a member of the International Center for Settlement of Investment Disputes (ICSID) since 1966.

--Performance Requirements and Incentives

Broadly speaking, Iceland does not offer direct subsidies for business investment. Its prime incentives lie in providing for a favorable environment for businesses, including low corporate tax rates and low energy prices. Industrial sites are available around Iceland at competitive cost. Local communities may offer certain additional incentives.

As a member of the EEA, Iceland has access to EU research funds for R&D programs and joint ventures can be undertaken with companies from at least one other EEA country. Grants are issued for specific projects on a case-by-case basis by bodies including the New Business Venture Fund and Science Fund.

Film and TV production in Iceland are subsidized by the government in the form of a rebate of a portion of production costs. To qualify, the production company must be incorporated in Iceland. An Icelandic branch or a representative office of a corporation registered in one of the EEA countries is considered as incorporated for these purposes. There are no requirements as to the production budget, but the film should promote Icelandic culture as well as introduce Iceland's history and natural beauty. The film and TV production cost rebate rate is currently 14 percent.

--Right to Private Ownership and Establishment

Other than in fishing, energy, and airlines, foreign entities are free to establish and own any type of business enterprise and engage in all forms of legal remunerative activity. If a foreign citizen from outside the EEA wishes to purchase land or real estate in Iceland, a permit is required from the Ministry of Justice.

Icelandic law treats private and public enterprises with equality when it comes to market access and other business operations. Foreign investors are permitted to participate in the privatization of government-owned businesses, subject to restrictions imposed by the government.

A foreign party must solicit an identity number (kennitala) before establishing a bank account. The process typically takes less than a week.

--Protection of Property Rights

Iceland adheres to key international agreements on property rights (e.g., Paris Union Convention for the Protection of Industrial Property). Trademarks, copyrights, trade secrets and industrial designs are all protected under Icelandic law. As with many other issues, Iceland is following the European lead in protection of property rights and adheres to the European Patent Convention of 1973. In 2005, Iceland signed the Patent Cooperation Treaty (PCT).

Iceland is a member of the EEA and therefore accepts jurisdiction of the EEA Court. Property Rights are recognized and protected in the Constitution of Iceland. Secured interests in property are bound by law and enforced as such and there is a very reliable system which records such security interests.

The Icelandic Patent Office -- a governmental agency under supervision of the Ministry of Industry and Commerce -- handles all patent disputes in Iceland. The legal framework concerning intellectual property rights (IPR) in Iceland is in all respects equivalent to that of other industrialized countries in Europe. Iceland is a World Trade Organization (WTO) member, and Icelandic legislation complies with WTO TRIPS requirements.

As an EFTA state and member of the EEA, Iceland has implemented all relevant EU regulations and directives in the field of IPR. Furthermore, Iceland is bound by bilateral EFTA free-trade agreements which include provisions on IPR.

Iceland is a member of the European Patent Organization. Iceland is a member of WIPO and a party to most WIPO-administered agreements.

--Transparency of Regulatory System

Icelandic laws regulating business practices are consistent with those of most OECD member states, and are increasingly based on European Union directives as a result of Iceland's EEA membership. Much of Iceland's financial regulatory system was put in place only in the 1990s, thus transparency is occasionally a concern (i.e. in public procurement, and in privatization sales where the process is established by the government on an ad hoc basis).

The Competition Authority is responsible for the enforcement of anti-monopoly regulations and promotion of effective competition in business activities. This includes eliminating unreasonable barriers and restrictions on freedom in business operations, preventing harmful oligopoly and restriction of competition and facilitating the access of new competitors to the market.

The Consumer Agency holds primary responsibility for market surveillance of business operators, transparency of the markets with respect to safety and consumers' legal rights, and enforcement of legislation concerning protection of consumers' health, legal and economical rights.

The system as a whole is transparent, though bureaucratic delays can occur. All proposed laws and regulations are published in draft forms for the public record and are open for comment.

Legislative Process: The Icelandic parliament (Althingi) consists of a single chamber of 63 members and a simple majority is required for ordinary bills to become law. All bills that are introduced in the parliament are in draft form. Drafts are open to the public and are published on the parliament's web page. Interested parties can comment on proposed law and regulations. All NGOs involved are summoned to comment on proposed laws that affect them.

--Efficient Capital Markets and Portfolio Investment

The financial sector is currently in great turmoil. In October 2008 the banking system collapsed and the Financial Supervisory Authority of Iceland took control over the three big Icelandic commercial banks. Resolution Committees were appointed that split each bank into two entities, a domestic one and an international one, and subsequently appointed new CEO's over the domestic entities. The banking system is being restructured and the banks' assets are being reevaluated. The supply of capital is limited as the banks were recapitalized by the Government as funding on the international wholesale capital markets was difficult to obtain. It is likely that Iceland will see a flood of personal and business bankruptcies in early 2009 across all sectors, including investment banks and other financial institutions.

The OMX Nordic Exchange operates the market for securities in Iceland and trades various products. The prices of companies listed on the OMX have fallen greatly in the recent past.

--Political Violence

At the time of this report's drafting in January 2009, Iceland experienced intense political protests stemming from the October 2008 financial crisis. Public protests spurred the government to dissolve and a new coalition to form prior to early elections in spring 2009 (originally scheduled for spring 2011.) Although this is presently an uncertain time, most expect political stability to return. There has been no politically motivated violence towards foreign holdings.

--Corruption

Isolated cases of corruption occur but are not an obstacle to foreign investment. In a 2008 survey by Transparency International, Iceland tied for the seventh out of 180 countries for the least corrupt. In 2007, Iceland was ranked sixth and in 2006, Iceland tied for the first place.

--Bilateral Investment Agreements

The U.S. does not have a bilateral investment treaty (BIT) with Iceland nor an FTA with the U.S. There is a U.S.-Iceland bilateral taxation treaty and a Trade and Investment Cooperation Forum Agreement (TIFA).

--OPIC and Other Investment Insurance Programs

Political risk insurance and project financing were readily available at competitive rates on the local and international markets. With the financial collapse in fall 2008 and the current rebuilding in the banking sector, project financing may be temporarily limited. Iceland is a member of Multilateral Investment Guarantee Agency.

--Labor

Until the financial collapse in fall 2008, demand for labor exceeded supply. According to Statistics Iceland the unemployment rate of the workforce, which consisted of more than 80 percent of the population, was less than 3 percent over the period 2005-2007. Many large construction projects, requiring a large number of skilled and unskilled workers, were built during that period. The Icelandic workforce is highly skilled. Foreign labor moved to Iceland to fill the majority of unskilled service and semi-skilled construction jobs; the number of foreign citizens residing in Iceland doubled. With the EEA agreement, free movement of labor from the EU quickly became the norm, and was embraced by local firms as a solution for their manpower shortage at times of extremely low unemployment. The labor market conditions changed dramatically following the fall 2008 economic crisis. The unemployment rate rose rapidly, from under 2 percent to 6.5 percent in three months. Unemployment is expected to rise, with foreign and domestic labor leaving Iceland for better job prospects.

The Icelandic labor market is highly unionized with more than 85 percent of employees belonging to unions. A joint negotiating committee with representatives from national and local governments, Iceland's largest banks, and several other large employers negotiates an annual collective wage agreement with the unions representing workers in the public sector and some parts of the private sector. Iceland has ratified around 20 ILO conventions, including those that protect the basic worker rights.

The government has imposed mandatory mediation when strikes have threatened key sectors in the economy such as the fishing industry.

--Foreign Direct Investment Statistics

Foreign investment statistics: The tables reflect data available as of January 2008. Figures on investment position refer to book value. These figures are limited to companies in which a single foreign investor holds 10 percent or more of the equity capital and do not include foreign ownership interests via third party investment. Investment flow statistics are based on market value.

Major foreign investors: Under Icelandic law, investment statistics gathered by the Central Bank and Icelandic Bureau of Statistics cannot be released on a company- or project-specific basis. Major U.S. investors in Iceland include: Century Aluminum, Alcoa (aluminum), and deCODE Genetics (biotech). Many U.S. companies are represented through Icelandic agents.

Information in this chapter was primarily obtained from the Central Bank of Iceland.

¶3. (U) End report.

VAN VOORST